

## Message Text

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E.O. 11652: N/A

TAGS: ECON, BE

SUBJECT: INFLATION IN BELGIUM: POSSIBLE CONSEQUENCES

REF: (A) 75 BRUSSELS 10705, (B) 75 BRUSSELS 10252, (C) 75 BRUSSELS 8578

(D) 75 BRUSSELS 8650, (EL 75 BRUSSELS 9303

1. SUMMARY: THE TINDEMANS GOVERNMENT HAD SCANT SUCCESS LAST YEAR IN EASING BELGIUM'S WAGE-LED INFLATION RATE, WHICH WAS 11 PERCENT. ITS FRUSTRATION WAS CAPPED BY ITS FAILURE LAST FALL TO GAIN POLITICAL SUPPORT FROM LABOR FOR A TEMPORARY INCOMES POLICY AND SALARY INDEXATION REFORM AIMED AT SLOWING DOWN THE REAL GROWTH OF MOST WAGES IN A TIME OF DECREASING PRODUCTIVITY. FOR 1976, GOVERNMENT IMPLEMENTATION OF THE REMAINS OF THIS PROGRAM PLUS REPLACEMENT OF THE OUTDATED INDEX ITSELF AND SOME AD HOC JAWBONING ARE NOT LIKELY TO

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HAVE MUCH EFFECT ON PRICES. OTHER ECONOMIC INDICATORS ARE

MIXED, AND THE BEST GUESS IS THAT THE INFLATION RATE THIS YEAR WILL PROBABLY COME CLOSE TO THAT OF 1975. SUCH A HIGH PLATEAU IS WORRISOME, HOWEVER, FOR A COUNTRY SO SUSCEPTIBLE TO EXTERNAL FORCES. A WORSENING OF GLOBAL INFLATION WOULD LIKELY BRING ANOTHER PRICE-WAGE SPIRAL, AGAINST WHICH TRADITIONAL DEMAND-MANAGEMENT TOLLS WILL CONTINUE TO BE OF LIMITED USE.

2. THERE IS THUS LITTLE CHOICE FOR BELGIUM FOR THE FORESEEABLE FUTURE BUT TO ADJUST TO LIFE WITH A HIGH-COST ECONOMY. ONE LIKELY RESULT WILL BE MORE ATTENTION TO VARIOUS STRUCTURAL FACTORS. IN PARTICULAR, BELGIUM WILL PROBABLY HAVE TO REFORM ITS SALARY INDEXATION SYSTEM SOONER OR LATER. THE GOVERNMENT'S DILEMMA IS HOW TO OBTAIN LABOR'S AGREEMENT TO THIS WHILE PRICES ARE STILL RISING AT A RAPID PACE. ITS SUCCESS (OR GOOD LUCK) IN GETTING OUT OF THIS VICIOUS CIRCLE WILL DETERMINE WHETHER INFLATION BECOMES AN INCREASINGLY DIVISIVE ISSUE, TESTING THE SOCIAL AND ECONOMIC SYSTEM BUILT HERE SINCE WORLD WAR II. END SUMMARY.

3. DURING 1975 THE TINDEMANS GOVERNMENT HAD SCANT SUCCESS IN EASING INFLATION IN BELGIUM. WHILE THE ANNUAL RATE OF PRICE INCREASE DROPPED FROM AN ALL-TIME HIGH OF 15.7 PERCENT IN 1974 TO 11 PERCENT LAST YEAR, BELGIAN INFLATION STILL EXCEEDED THAT OF ITS CHIEF EUROPEAN NEIGHBORS AND TRADING PARTNERS AS WELL AS THE OECD AVERAGE. NEITHER THE RECESSION, WHICH SHRUNK REAL GNP BY AN ESTIMATED 2 PERCENT AND IDLED 8.7 PERCENT OF THE COUNTRY'S WORK FORCE BY YEAR'S END, NOR A PROGRAM OF PARTIAL PRICE FREEZES FROM APRIL ON HAD THE DEFLATIONARY EFFECTS EXPECTED. IN FACT, PRICES ACCELERATED MORE RAPIDLY IN THE FINAL QUARTER OF 1975 THAN IN ANY OF THE THREE PRECEDING QUARTERS. THIS HAS BEEN A FRUSTRATING EXPERIENCE FOR A COUNTRY WHICH, BEFORE 1973, HAD ONE OF THE LOWEST INFLATION RATES IN THE INDUSTRIALIZED WORLD. IT HAS CONTRIBUTED TO REMARKABLE LOW LEVELS OF BUSINESS CONFIDENCE HERE DURING THE PAST YEAR, AS MEASURED BY EC SURVEYS, AND HAS FUELED A HEATED DEBATE OVER BELGIUM'S 30-YEAR-OLD SYSTEM OF SALARY INDEXATION (SEE REFTELS).

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4. CURRENT INFLATION IN BELGIUM IS LARGELY WAGE-LED, STEMMING FROM THE OIL, GRAIN AND OTHER COMMODITY PRICE INCREASES OF LATE 1973. THEIR COMBINED EFFECT SENT THE COST-OF-LIVING INDEX UP 9 PERCENT DURING THE FIRST SIX MONTHS OF 1974. UNDER BELGIUM'S INDEXATION SYSTEM, THIS RISE TRANSLATED INTO AUTOMATIC AND ALMOST IMMEDIATE SALARY INCREASES OF THE SAME DIMENSION FOR ALMOST ALL BELGIAN WORKERS, LEADING TO FAST-SPREADING MULTIPLIER EFFECTS THROUGHOUT THE ECONOMY.

INDUSTRIAL SALARIES, IN FACT, ROSE EVEN FASTER THAN THE INDEX, 46.4 PERCENT OVER THE TWO-YEAR PERIOD 1974-75, DESPITE THE RECESSION'S DROP IN PRODUCTIVITY. THE POTENTIAL OF THIS FOR DAMAGE TO BELGIUM'S VITAL EXPORT COMPETITIVENESS HAS BEEN CLEAR FOR SOME TIME. ACCORDING TO AN EC STUDY, FOR EXAMPLE, THE PHENOMENON PULLED BELGIAN WAGES FROM A LEVEL 23 PERCENT BELOW THOSE IN WEST GERMANY (BELGIUM'S MAIN EXPORT AND INVESTMENT COMPETITOR) TO 3 PERCENT OVER THE GERMAN FIGURE BY LATE LAST YEAR.

5. THE GOVERNMENT'S ONE MAJOR ATTEMPT TO DEAL WITH THE PROBLEM, LAST FALL'S PROPOSED INCOMES POLICY AND TEMPORARY INDEXATION REFORM, FAILED OF POLITICAL SUPPORT FROM LABOR AND HAD TO BE LARGELY ABANDONED (SEE REFTELS). AT PRESENT, ALL THAT REMAINS OF THE PROPOSAL IS A NINE-MONTH SUSPENSION OF MAINLY WHITE-COLLAR AND PROFESSIONAL SALARY INDEXATION PLUS A TEMPORARY FREEZE ON VARIOUS TYPES OF NON-WAGE INCOME (SEE BRUSSELS 10705). IN RECENT WEEKS, THE GOVERNMENT HAS MADE A NUMBER OF CONCESSIONS ON HOW IT WILL APPLY EVEN THIS LIMITED PROGRAM; THESE CHANGES WILL FURTHER WEAKEN ITS POSSIBLE ECONOMIC EFFECT. PERHAPS FOR THESE REASONS, THE PROGRAM IS NOT BEING PUSHED IN THE PARLIAMENT AND IS NOW EXPECTED TO PASS ONLY IN MARCH OR APRIL. WORK ALSO CONTINUES ON THE REPLACEMENT OF BELGIUM'S BADLY OUTDATED PRICE INDEX WITH A BROADER, MORE REPRESENTATIVE MARKET BASKET, HOPEFULLY BY THIS SPRING. OTHERWISE, THE GOVERNMENT HAS BEEN ACTING ON AN AD HOC BASIS TO STABILIZE THE OLD INDEX TO THE EXTENT POSSIBLE. IT HAS FROZEN THE PRICE OF POTATOES WHICH HAD BEEN RISING AND WHICH HAS A DISPROPORTIONATE WEIGHT IN THE INDEX. IT IS ALSO ENGAGED IN A RUNNING AND SO FAR UNRESOLVED DISPUTE WITH DOCTORS' GROUPS IN AN ATTEMPT TO POSTPONE RETRAINING FEE PREMIUMS WHICH WERE TO COME INTO FORCE THIS YEAR (BEING REPORTED SEPARATELY).

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6. THESE MEASURES, SUCH AS THEY ARE, ARE NOT LIKELY TO HAVE MUCH EFFECT ON PRICES DURING 1976. AS FOR ECONOMIC DETERMINANTS, THE OUTLOOK IS MIXED. ON THE PLUS SIDE, IF INDUSTRIAL PRODUCTION PICKS UP DURING THE YEAR AS EXPECTED, THERE SHOULD BE CORRESPONDING GAINS IN PLANT PRODUCTIVITY. UNEMPLOYMENT WILL REMAIN HIGH (MINISTER OF ECONOMIC AFFAIRS HERMAN PRIVATELY PREDICTS A RATE CLOSE TO THAT AT PRESENT, PROBABLY THROUGH THIS YEAR) WHICH COULD MODERATE LABOR UNION CONTRACT DEMANDS. EC AGRICULTURAL PRICES, A PRIMARY ELEMENT IN LOCAL INFLATION OVER THE LAST TWO YEARS, WILL RISE AGAIN, BUT THE RATE OF INCREASE MAY WELL BE SLOWER. LESS ENCOURAGINGLY, BUSINESS AND GOVERNMENT DEMAND FOR BANK CREDIT IS LIKELY TO BE MUCH STRONGER THAN LAST YEAR, MEANING HIGHER INTEREST RATES. MOREOVER, SOME COMPANIES WILL ALSO MOVE TO

REESTABLISH PROFIT MARGINS BY RAISING PRICES, IF AND WHEN  
PRODUCTION DOES PICK UP. INCREASED DEMAND COULD ALSO BRING  
REAPPEARANCE OF LOCAL BOTTLENECKS AND SHORTAGES (PARTICULARLY  
IN SKILLED MANPOWER) WHICH HAVE BEEN A PROBLEM SINCE THE  
RAPID BUILD-UP OF FOREIGN-OWNED INDUSTRY HERE IN THE 1960'S.  
ON BALANCE, THE BEST GUESS SEEMS TO BE THAT PRICES WILL

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RISE SOMEWHERE BETWEEN THE OECD'S PROJECTED 12 PERCENT AND  
THE GOVERNMENT'S PREDICTION OF 9.3 PERCENT; I.E., ROUGHLY  
THE SAME PERFORMACE AS LAST YEAR.

7. THIS IS AN UNCOMFORTABLY HIGH PLATEAU, HOWEVER, FOR A  
COUNTRY SO SUSCEPTIBLE TO EXTERNAL FORCES. TRADE ACCOUNTS  
FOR OVER HALF OF GNP; ON THE IMPORT SIDE, IT IS HEAVILY  
DEPENDENT ON RAW OR SEMI-PROCESSED COMMODITY MARKETS AND  
CONSUMER GOODS PRIMAILY FROM A FEW EC PARTNERS. A WORSENING  
OF GLOBAL INFLATION THIS YEAR OR IN 1977, EVEN IF ONLY IN  
CERTAIN COMMODITIES, COULD CONDEMN BELGIUM TO ANOTHER

INTERNAL AND "FULLY-AUTOMATED" PRICE-WAGE SPIRAL REMINISCENT OF 1973-74, BUT THIS TIME FROM A MUCH HIGHER INFLATIONARY BASE.

8. TRADITIONAL DEMAND-MANAGEMENT TOOLS WILL CONTINUE TO BE OF LIMITED USE IN DEALING WITH CURRENT INFLATION OR LIMITED OFFICIAL USE

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WITH ANY NEW PRICE EXPLOSION. FISCAL POLICY WILL PROBABLY REMAIN STIMULATIVE FOR THE FORESEEABLE FUTURE, REGARDLESS OF ECONOMIC CONDITIONS. THERE APPEARS TO BE LITTLE CHANCE OF REVERSING THE TREND OF GROWING BUDGET DEFICITS IN RECENT YEARS IN PART TO MEET SOCIAL NEEDS (NOW INCLUDING INCREASED HARD-CORE UNEMPLOYMENT LEFT BY THE RECESSION) AND TO CARRY OUT LINGUISTIC REGIONALIZATION PROGRAMS. FINANCING OF THE 1976 BUDGET DEFICIT WILL RISE TO AN ESTIMATED BF 200 BILLION OR ABOUT 8 PERCENT OF BELGIAN GNP. THIS IMPLIES PRESSURE PROBABLY AT LEAST INTO 1977 FOR EXPANSIONIST MONETARY POLICIES AS WELL, BOTH TO FUND THE BUDGET DEFICIT AND TO SUPPORT ECONOMIC RECOVERY. ON THE EXTERNAL SIDE, DEVALUATION IS UNLIKELY IN THE NEAR TERM SINCE THE BELGIAN BALANCE OF PAYMENTS AND RESERVE POSITION IS CURRENTLY STRONG. IF EXPORT COMPETITIVENESS CONTINUES TO DECLINE, HOWEVER, DEVALUATION OF THE FRANC WOULD BECOME DIFFICULT TO AVOID. BUT THERE WOULD BE RESISTANCE TO SUCH AN ADJUSTMENT BECAUSE BELGIUM IS A RESOURCE-POOR PROCESSING NATION WHERE MORE EXPENSIVE IMPORTS SIMPLY ADD TO INDUSTRIAL COSTS.

9. BELGIUM THUS HAS LITTLE CHOICE FOR THE FORESEEABLE FUTURE BUT TO ADJUST TO LIFE WITH A HIGH-COST ECONOMY. ONE LIKELY RESULT WILL BE MORE ATTENTION TO STRUCTURAL FACTORS MORE OR LESS IGNORED DURING THE PROSPERITY OF THE '60S. FOR EXAMPLE, THE ATTRACTION OF BELGIUM FOR FOREIGN INVESTORS DURING THE '60S, HEAVILY BASED ON RELATIVELY LOW LEVELS OF BOTH WAGES AND WORKER FRACTIOUSNESS, HAS BEEN ERODED BY EVENTS SINCE 1973. DIRECT FOREIGN INVESTMENT MAY THUS NOT PROVIDE THE SAME CUTTING EDGE OF BELGIAN EXPORT COMPETITIVITY THAT IT DID IN THE LAST DECADE, AND ALTERNATIVES MAY WELL BE NECESSARY. OTHER PROBLEMS INCLUDE ANTIQUATED ACCOUNTING PRACTICES WHICH TEND TO DISCOURAGE TECHNOLOGICAL INNOVATION, CARTEL PRICE-SETTING BY MAJOR INDUSTRIES AND BANKS, THE VIRTUAL ABSENCE OF PROGRAM BUDGETING AT ANY GOVERNMENT LEVEL, AND AN EXPENSIVE (ALTHOUGH BELOVED) RETAIL DISTRIBUTION SYSTEM BUILT ON THE SMALL SHOPKEEPER. THERE IS ALSO THE MAJOR SOCIO-ECONOMIC DILEMMA OF WALLONIA WHERE A BLEND OF HIGH STRUCTURAL UNEMPLOYMENT, OFTEN OUTMODED INDUSTRY, AND LABOR UNION MILITANCY THREATENS TO UNBALANCE INDUSTRIAL RELATIONS THOROUGHOUT THE COUNTRY.

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10. FINALLY, IT IS HARD TO AVOID THE CONCLUSION THAT BELGIUM MUST SOONER OR LATER REFORM ITS SALARY INDEXATION SYSTEM. THIS DOES NOT NECESSARILY MEAN ABOLISHING IT. THE SYSTEM WORKED WELL HERE FOR OVER 25 YEARS, UNTIL THE PERVERSE EFFECTS OF 1974-75. IN MANY WAYS, IT REMAINS WELL SUITED TO BELGIUM'S PARTICULAR ECONOMIC AND SOCIAL CIRCUMSTANCES. THE DILEMMA WHICH FACES THE CURRENT GOVERNMENT, AND POSSIBLY ITS SUCCESSORS, IS THAT LABOR MAY WITHHOLD ITS NECESSARY CONSENT TO REFORM UNTIL PRICES DROP SIGNIFICANTLY--BUT THAT A MEANINGFUL CHANGE IN AT LEAST SOME INDEXATION MECHANISMS (E.G., EXTENDING THE PRICE INCREASE-SALARY INCREASE LAG) MAY BE REQUIRED TO ACHIEVE THIS. THERE MAY BE SOME ROOM FOR AN EXIT FROM THIS VICIOUS CIRCLE IF GLOBAL INFLATION RATES, PARTICULARLY IN THE OTHER INDUSTRIALIZED COUNTRIES, SUBSIDE FOR A SUSTAINED PERIOD, INEVITABLY REVERSING THE ENGINES OF BELGIAN PRICES AS WELL. IF NOT, HOWEVER, INFLATION WILL LIKELY BECOME AN INCREASINGLY DIVISIVE ISSUE IN BELGIUM, TESTING THE SOCIAL UNDERSTANDINGS AND PRAGMATIC CAPITALISM WHICH HAVE ENRICHED ITS CITIZENS SINCE THE SECOND WORLD WAR. RENNER

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